RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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September 18, 1985 LETTER 922

Sept. 6 DJIA 1335.69; PTI 1929; A-D Ratio -14.40
Sept. 13 DJIA 1307.68; PTI 1907; A-D Ratio -15.77

THE PICTURE: In Letter 919 (page 2) I "put the odds for a full secondary correction at less than 50/50". In Letter 920 (August 21) I wrote: "Based on what I see so far, I'm raising the odds for a full correction to 75/25. In other words, I think it's going to happen." Then in Letter 921 (Sept. 5) I showed the "percentage of stocks holding above their 30-week moving average" study practically guaranteed a correction. As this Letter is written all doubts are dispersed -- the correction is now going on.

My own feeling (instinct) is that the correction was triggered by the shaky financial situation in the US and the world. Remember the history books and the great Dutch Tulip craze?Well, today it's the "Great World Debt Craze". People are going into debt, corporations are selling debt, cities are swimming in debt, nations are drowning in debt. And the financial markets are beginning to regurgitate.

How do I know? Easy, I follow the NYSE Financial Index. This Index is made up of all the financial issues on the Big Board from banks to savings & loans to small loan companies to brokerage houses. Study the chart on page 2. Note that the NYSE Financial Index topped out at 122.80 on July 17. It has been sliding ever since, and in my opinion, this "slide of the financials" has set off the market correction. Will this slide go down in history as the beginning of the next primary bear market? I don't believe so. I could be wrong, but I don't believe so. I'll give you some of my reasons as follows.

Currently, I'm seeing an extraordinary amount of "This is 1929 all over again"-type literature. Joe Granville will be coming out in October with his new book, "The Warning". The book, says Joe, will include hundreds of comparisons of 1985 with 1929. Julian Snyder ("Moneylines") is predicting a worldwide recession or worse. Donald Hoppe warns of a Kondratieff-type collapse. The gold people are looking for a new round of super-inflation. And you know something -- all these arguments sound logical and even possible.

But before we jump overboard on the bear bandwagon, I want to give my fellow market advisors a warning. It goes like this: the last confirmation by the D-J Averages was a primary bull confirmation . And history suggests that we adhere to the Dow Theory principle which states that "the trend is taken to CONTINUE until proved otherwise". So one path the pessimists might take is to try to prove that instead of a primary bull market, we are now in a primary bear market. And how do you offer proof of the existence of a bear market? Frankly, you can't -- at least not at this time.

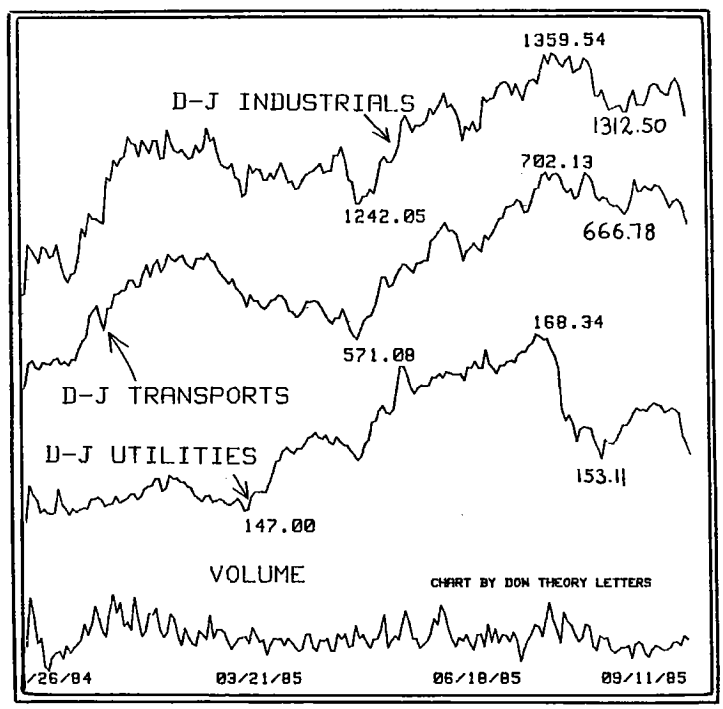
The fundamental (economic) bear arguments are out there for everyone to see and read about. The newspapers are chock full of bad news. American business is being killed by low-cost Asian production. The Treasury deficits are a disgrace. The Federal debt is eating us up alive. US purchasing agents are forecasting recession. Major corporations are laying off thousands of workers. Corporate profits are being squeezed. Tool orders are sliding, and on and on.

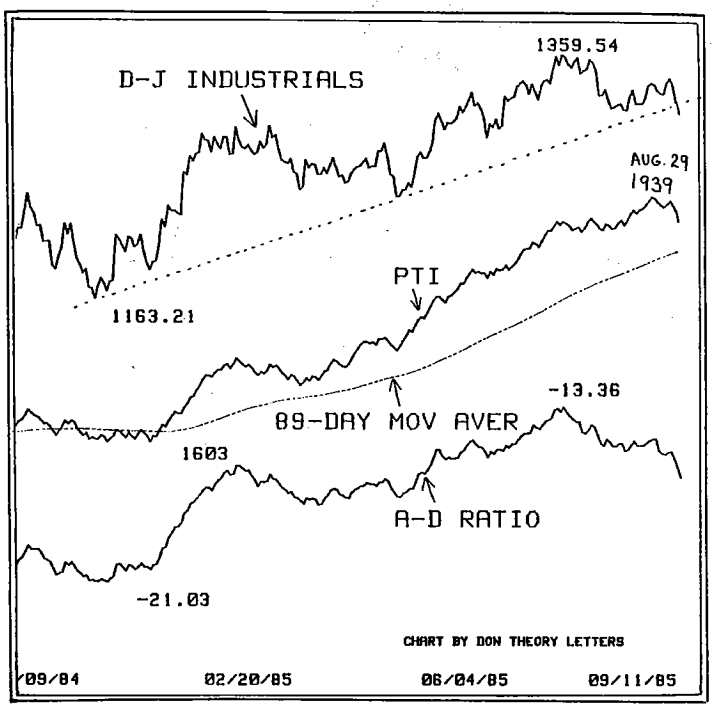
In view of this stream of bad news, why aren't we getting a Dow Theory bear signal? Is the stock market out of its bloody mind? Or is the stock market weighing evidence that the pessimists simply don't see?

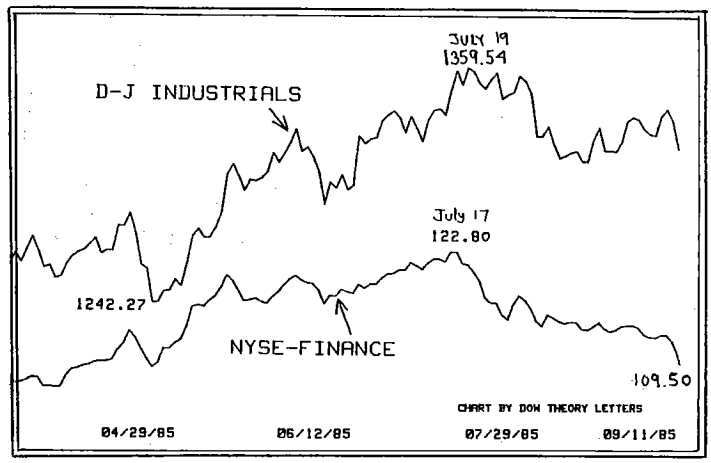
The fact is that we have been reading about rotten business news for many months now, and the market has merely backed off. And it has backed off reluctantly. None of the D-J Averages are near their 1985 lows (see page 1 chart) although any reading of the financial news would lead one to wonder why the 1985 lows have not already been shattered.

Let me present a few items that the bears may not be thinking about. First, the Fed has been increasing the money supply at the rate of 14.2% (annually) for the past three months, and so far there have been no signs of inflation. Without the inflation danger, it is possible that the Fed will continue its easy money policy until business turns up.

Any hints the situation is improving? Yes, the Bank Credit Analyst's debit/loan ratio is climbing, and the BCA notes that the nation's financial structure is now

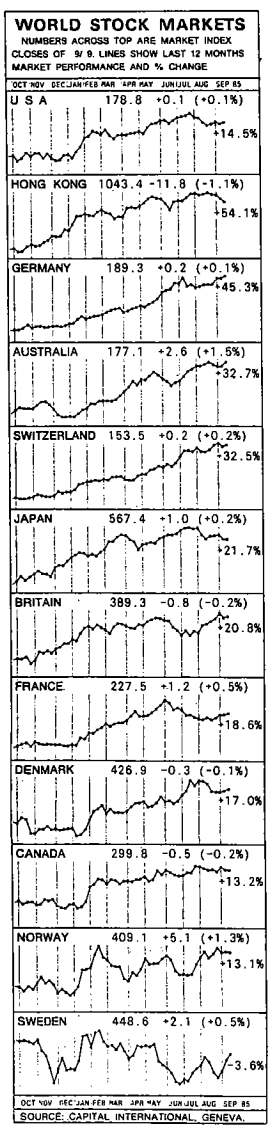


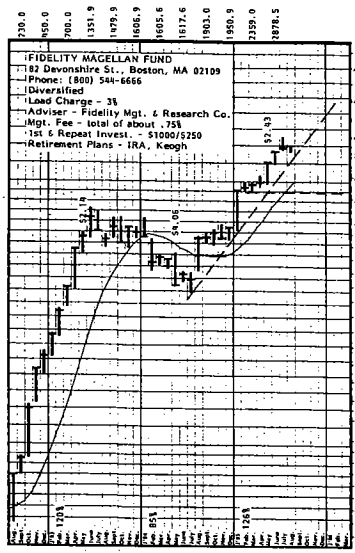




in the process of reliquefication. When the debit/loan ratio is rising (as it now is), it means that business activity is rising IN RELATION to loans. This is bullish. Historically, when the debit/loan ratio is climbing it is a prediction of a forthcoming rise in corporate profits. Thus, the free and easy Fed posture could be the item that this market likes. The market (by its holding action) may be saying that the next major move of the economy is UP.

I am including here the Investor's Daily charts of the US and 11 other major stock indices. As I have so often said, primary movements tend to be international in scope. In fact, I was one of the first advisories (back in the early 1960s) to offer charts of the various foreign markets. In those days you had to call the Swiss banks to get the statistics, but now, of course, it's a lot easier. At any rate, note that almost all the foreign stock indices are currently near their 1985 highs. This is bullish for the US markets. If a primary bear market was upon us, I would expect the foreign markets, at least a few of them, to be careening downhill.


WORLD STOCK MARKETS
NUMBERS ACROSS TOP ARE MARKET INDEX
CLOSES OF 9/ 9. LINES SHOW LAST 12 MONTHS
MARKET PERFORMANCE AND % CHANGE
OCT NOV DEC JAN FEB MAR APR MAY JUN JUL AUG SEP 85
U S A 178.8 +0.1 (+0.1%) +14.5%
HONG KONG 1043.4 -11.8 (-1.1%) +54.1%
GERMANY 189.3 +0.2 (+0.1%) +45.3%
AUSTRALIA 177.1 +2.6 (+1.5%) +32.7%
SWITZERLAND 153.5 +0.2 (+0.2%) +32.5%
JAPAN 567.4 +1.0 (+0.2%) +21.7%
BRITAIN 389.3 -0.8 (-0.2%) +20.8%
FRANCE 227.5 +1.2 (+0.5%) +18.6%
DENMARK 426.9 -0.3 (-0.1%) +17.0%
CANADA 299.8 -0.5 (-0.2%) +13.2%
NORWAY 409.1 +5.1 (+1.3%) +13.1%
SWEDEN 448.6 +2.1 (+0.5%) -3.6%
OCT NOV DEC JAN FEB MAR APR MAY JUN JUL AUG SEP 85
SOURCE: CAPITAL INTERNATIONAL, GENEVA.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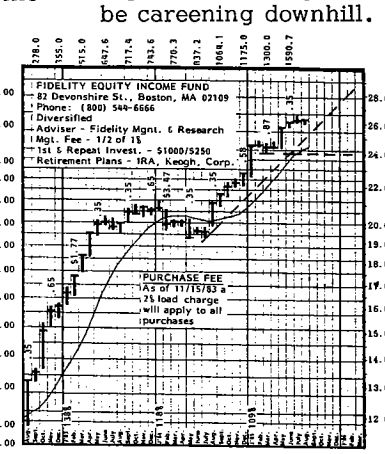
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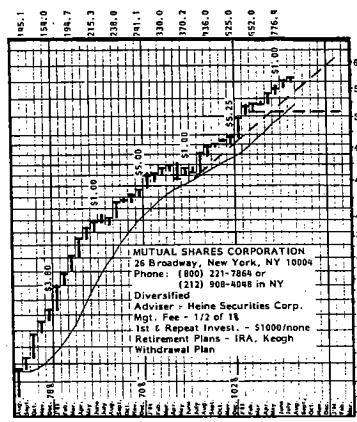
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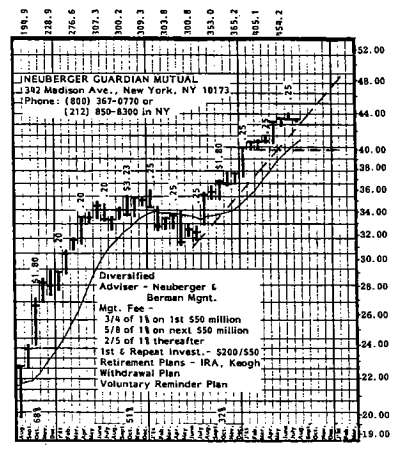
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Next item. I am including here monthly charts of four leading no-load funds (charts courtesy of Growth Fund Guide, Box 6600, Rapid City, SD 57709). All of these funds have been recommended by me in the past as good bull market vehicles. Note that all four funds are at or within a fraction of record highs. These funds have been excellent performers, but there are many other funds that have done just as well. My object here is not to point with pride to past recommendations. My point is that this is NOT the kind of action one sees during a bear market or even at a bull market top. Funds just don't advance to record highs when a bear market is developing. No, this is bull market action. These funds are at or near their highs because they have been good stock pickers and their stocks have done well -- even while the stock market in general has been sliding.

Secondary trend: In the last Letter I went into detail regarding my expectation of a secondary reaction in the stock market. I stated that a correction (1) could start slowly and end in scary fashion, and (2) such a correction could easily carry into the late-September to October period.

In my experience, there is nothing more difficult to deal with or predict than the secondary correction in a bull market. Robert Rhea, the great Dow Theorist of the 1930s, put it this way: "There is general recognition that it is practically impossible to determine with any degree of accuracy the beginning of a secondary reaction." William Hamilton (Rhea's brilliant teacher) stated, "Secondary reactions in a bull market are hard to guess and even the indications are sometimes deceptive."

At this point, I want to save my current market comments for the end of this Letter so that they will be as up-to-date as possible. So please turn to page 6 for my latest discussions of the market.

INVESTMENT POSITION: In the hippie 1960s, the chant was "give love a chance". Here in the debt-laden 1980s, I guess I would say, "Give the bull market a chance." We knew the bull was tired, we knew the odds favored a reaction. Now we're getting that reaction, and it's not pleasant. But the D-J Averages have not given a bear signal, nor has the PTI broken below its 89-day moving average. The bull remains in the box. He could be a bleeding bull before October-November is out, but he's still a bull.

STOCKS OR BONDS? Today everyone's a technician, so maybe it's time to go back to a few fundamentals. One of the oldest and most basic value studies compares the "earnings yield" for common stocks with the interest yield for bonds.

In this study we compare AA-rated bonds (investment grade bonds) with the D-J Industrial Average (which consists of investment grade stocks). The earnings for the Dow are currently about $102. Dividing 102 by the price of the Dow (1310) gives us an earnings yield of 7.78. Mind you, this is an earnings yield, not a dividend yield.

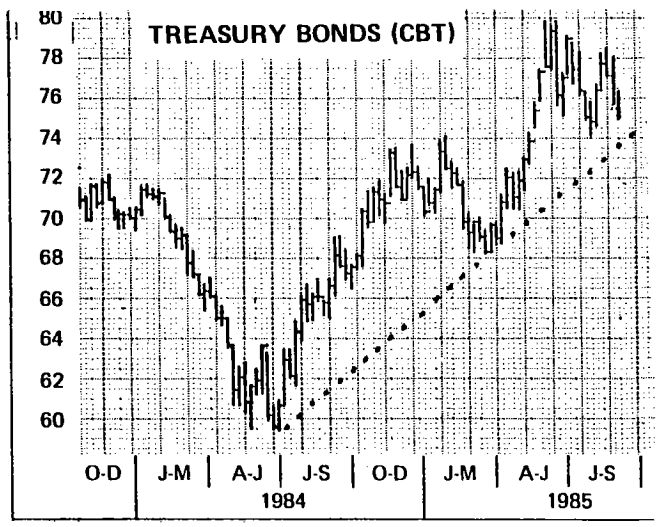
At the same time, the interest yield on the S&P AA-rated corporate bond average is 11.22. Thus there is an advantage of 3.44% in favor of bonds. This long-term chart (courtesy of Grant's Interest Rate Observer, (212) 608-7994) traces over a half a century of the earnings yield on the Dow minus the yield on the S&P AA-rated bonds. There are three things I want subscribers to note on this chart.

(1) The peak in stock values (vs. bonds) occurred during the 1947-49 period when the yield spread in favor of the Dow was over 10%. Nothing like this has been seen since, and it is no coincidence that the great bull market (in stocks) of the 1950s and '60s began during 1949.

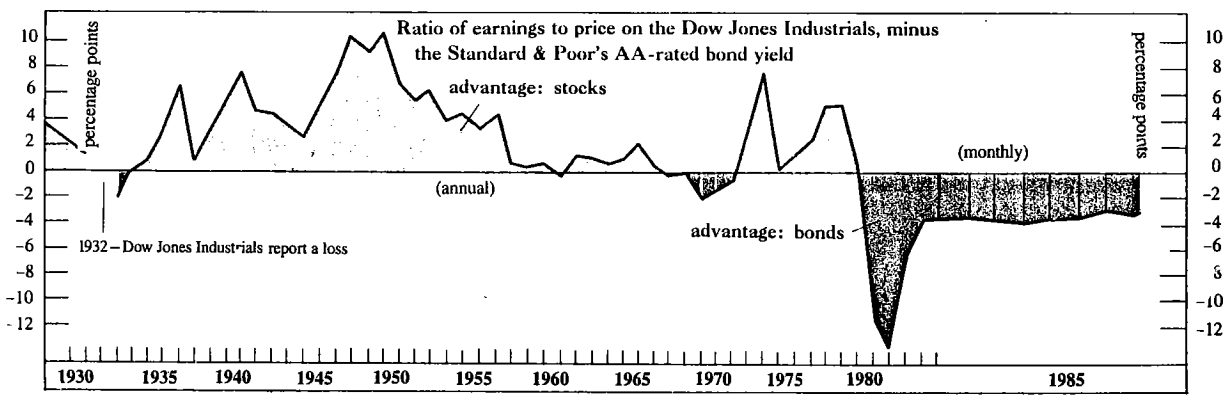
(2) The extreme yield peak for bonds occurred in 1982, at which point bonds offered a fantastic spread of 13% over the Dow. People who loaded up on bonds during 1982 have done very nicely, to say the least.

(3) The yield spread in favor of bonds is now around 3.5, still a hefty spread in favor of bonds. So simply stated, you are at this time getting more in value from bonds than you can get from stocks. This is not a prediction that you will do better buying bonds now than you would buying stocks now. But it does constitute a very fundamental test of the relative values of both markets.

BONDS, RATES: I continue to believe that bonds are in a trading range with the near-term futures moving between 73-74 on the downside and 80 on the upside. This Dunn & Hargitt chart shows the picture and you might note that the trendline comes in at about 73½. So I would say that at 73 or below on the September contract, the trend of bonds would be decisively bearish. But I'm guessing (I'm doing a lot of guessing in this Letter) that the bonds and therefore the rates will hold in the aforesaid trading range.

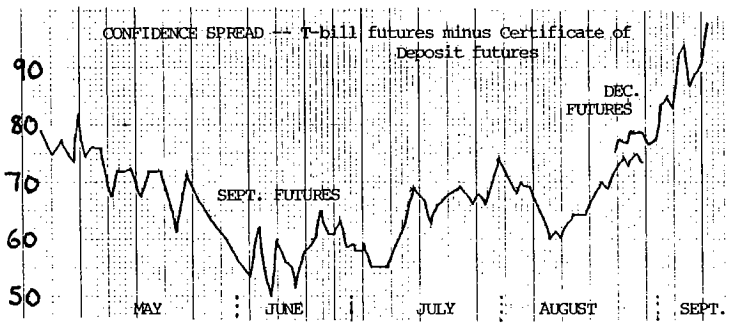


The municipal bonds continue to be attractive vs. the Treasuries with S&P's muni bond yields at roughly 88% of their long-term T-bond yields. To put it another way, long-term muni bonds (top-rated general



obligations of states) are around 9%, while comparable T-bonds are about 11%. Thus the tax-free bonds require giving up around 2% in yield -- pretty good for the muni buyer, in my opinion.

CONFIDENCE? One commodity spread I follow is the T-bill future minus the bank C/D spread. The chart shows the picture. When people are very confident about the financial picture they move into bank certificates of deposit because these C/Ds always yield more than the super-safe T-bills. Thus, back in June the spread between the two was only 50 basis points. Since then the spread has been widening as investors tended to move out of C/Ds and into safe T-bills. A high of 97 was hit on this spread last week.



I use the spread as a check on the health of the financial system, but many sophisticated traders actually buy the spread. The C/D and T-bill contracts are for $1 million each, and you buy a T-bill contract while shorting the C/D contract. The margin to buy this spread can be as low as $2,000 or even less! The spread is for $25 a point. For instance, if you had bought the spread in June at 50 and held it to the present you would have accumulated roughly 40 points and would have a paper profit of $1,000 per spread.

The spread is an interesting hedge against danger or a collapse in the banking system. It is also interesting because the downside is limited (since the C/Ds will never sell for the same price as the higher-quality T-bills). In case of disaster there is almost no limit to how far the spread will widen as people dump C/Ds to buy T-bills.

I don't recommend this kind of adventure in trading to my average subscriber, but for those who want to profit from a banking scare, this spread is one way to go. As I said, however, I chart this spread simply as a check on the health of the financial markets. It's a fascinating indicator.

DEBT: If anyone has been warning about the US debt build-up for longer than I have, I don't know who it could be. I list the following (and I'm serious about this) as the two great "disaster-mistakes" in American history. (1) The Vietnam war, which resulted in 50,000 needless American casualties and cost this nation upwards of $140 billion (all wasted money). (2) The series of horrendous deficits that have resulted in a US national debt which will be over $2 trillion by the time President Reagan says goodbye. This clip from the Sept. 4 NY Times will give you some idea of the scope of the debt disaster.

THE rapid growth of the Federal Government's debt has been the focus of a great deal of public concern in recent years. But much less attention has been paid than is due to the even greater explosion of private debt.

Total outstanding debt in the United States has more than doubled in the past seven years, increasing from $3.3 trillion at the end of 1977 to $7.1 trillion at the end of 1984. While the Federal debt was rising by $754 billion during that period, private debt was climbing by $2.3 trillion.

In just the past two years, total debt outstanding increased by nearly $1.5 trillion. In the final quarter of 1984, total debt, private and public, was climbing at an annual rate of $1 trillion for the first time in history. Last year the Federal Government borrowed $198.8 billion to finance its deficit while private businesses and households added $535 billion to their debts.

With $7.1 trillion in total debt, we are talking about total annual interest payments in the US of roughly (figuring at a conservative 10%) $700 billion a year or almost $14 billion a week! What has enabled the US and its citizens to carry such gigantic levels of interest? Three things: (1) inflation, (2) foreigners' willingness to accept US paper, and (3) the Fed's willingness to keep the money supply rocketing.

But what scares the Fed and everybody who knows anything about it is a single question: "What happens if the nation goes into a steep recession or depression and income falls off precipitously?" How, during a big economic contraction, can the nation come up with $14 billion a week to service its collective debt? If you know enough to ask that question, you know why the Fed is aggressively printing money. Why, with the Fed opening the monetary spigots, aren't we seeing inflation? I've said this before and I'll repeat it -- because the debt monster is acting like a giant sponge, sopping up liquidity as fast as it is created.

"But," you ask, "what exactly about the debt could cause a depression?" My answer, a depression would be caused by a collapse of the US and world debt structure. In the space of a few weeks or months, literally trillions of dollars of debt could be unmanageable or uncollectible and therefore wiped out. The third world debt could be reneged on overnight, a run on the US banks could occur, people could walk away from their mortgages rather than keep up payments on homes that were plunging in value, junk bonds could smash to 10¢ on the dollar, Treasury bonds could plunge as their value came into question. In the space of a fortnight, trillions of dollars worth of debt could be rendered literally worthless.

This entire debt picture offers the basic scenario for the next great bear market and depression. But whereas during the Great Depression of the 1930s, the dollar was considered "as good as gold", what will happen to the dollar in the next depression? I have been pondering this question for years, and frankly I don't think I or anyone else can come up with THE answer.

My only solution to survival in the face of the next bear market is via the path of DIVERSIFICATION. In a bear market everyone loses, and the winner is the one who loses least. Diversification in the face of the ultimate debt collapse might consist of (1) a home, (2) cash or a checking account, (3) short-term Treasury notes or bills, (4) gold coins, (5) highest grade corporate bonds, (5) top-rated general obligation bonds from your own state or your state capital, (6) Swiss francs or Japanese yen. Most of these items would, I suspect, survive a collapse of the debt structure. Whether their purchasing power would hold up is another question, but one can't be greedy during a bear market.

Note of Interest: Tony Boeckh (editor of the Bank Credit Analyst) expects a "major" improvement in the economy next year with short-term (right, short-term) interest rates up as much as 3% above current levels. He expects the rate rise to begin in a few months. Tony's forecast is exactly opposite to that of the Levy's (Industry Forecasts). I'll just continue to follow the MARKETS.

NOTES & QUOTES: All our liberals (including the Congress) are only too eager to topple the white government of South Africa. But do any of these geniuses have plans for what to do if South Africa falls? Before we turn S. Africa into another Zimbabwe, we might ponder these items from the Sept. 11 Christian Science Monitor:

> **Hurtling population growth is literally eating up African food production gains, overloading economic growth, and overwhelming much of the environment.**
>
> **At 3 percent a year, African population growth is the fastest of any continent on earth.**
>
> **True, many states have large areas and small aggregate numbers of people.**
>
> **Yet, say UN officials, people are densely packed into the much smaller areas that are actually livable — and it is the rate at which they are mushrooming that is formidable.**
>
> **UN figures show that black Africa is likely to leap from 383.7 million people today to 644.8 million in the year 2000 and to 1.27 billion by 2025. Almost 1 African in every 2 is aged 14 or under.**
>
> **Africa is the only continent "failing to keep food production ahead of population growth," warns the UN Food and Agriculture Organization in Rome in its 1985 World Food Report.**

* *

People often suggest new fiction books for me to read, but I tell them that with a few exceptions I never read fiction. Why? Because non-fiction is informative and (to me) more interesting. For instance, a new book entitled, "Bound Over: Indentured Servitude and the American Conscience" by van der Zee (Simon and Schuster), tells the extraordinary story of indentured servitude in the US (finally abolished in the 1820s). Children could be bound over until age 21 and adults could be bound over for a period of up to 14 years. Those bound over were debtors, paupers, deserters and criminals.

It's hard to believe, but one of our Presidents was an indentured servant. Andrew Johnson's father died when he was 4, and Johnson and his brother were bound over in servitude to a tailor. A year later they escaped, and (can you believe this?) there was a $10 reward put out for their capture. The reward ran, "$10 reward for ... Andrew Johnson, of dark complexion, eyes and habits, a harum-scarum boy." This runaway indentured servant became President of the United States. Talk about truth being stranger than fiction.

* *

The depression in US farming is even worse than the pessimists expected. The farm banks (banks with 25% or more of their loans in agriculture) hold $51 billion of the nation's $210 billion in farm debt. It is estimated that about half of all the farm banks' loans are now uncollectible. The collapse in farm land values has eroded as much as half of the collateral of the loans made in the 1970s and early '80s. Of the 76 banks that have failed this year, 42 have been farm banks. But the most frightening statistic is that total farm income, which was $33 billion last year, is expected to drop 60% to $13 billion this year. Is it any wonder that the Fed is trying to reliquefy the economy?!

* *

The most dramatic disaster in shipping history was the sinking of the "unsinkable Titanic" in which 1513 people died in 1912. Many of the people were the cream of America's wealthy. Recently, the remains of the Titanic were found under 2.5 miles of ocean.

Clive Cussler (author of "Raise the Titanic") was quoted last week in USA Today on the Titanic's rediscovery:

> **"It's the most difficult wreck that's ever been found," treasure salvor Robert Marx said Tuesday. "You're talking about mission impossible. Nobody has ever found anything that deep."**
>
> **The drama of the Titanic's sinking lives on, Cussler said, because it took two hours and 40 minutes for the supposedly unsinkable ship to go under, allowing ample time for heroics and sacrifice among the wealthy passengers facing death.**
>
> **"The sinking of the Titanic was the end of an era," Cussler said. "The wealthy of that era were gods and goddesses, like rock stars and sports stars are today, and when the Titanic sank, all of a sudden the public found out that these people on their pedastals drowned as easily as everyone else."**
>
> **There are haunting vignettes — millionaire industrialist Charles Guggenheim putting on his finest evening clothes so he could go down "like a gentlemen;" the ship's band playing a hymn in the final moments.**

* *

Quotes to ponder: From Joseph Cotton's piece on Orson Welles in Los Angeles magazine (Welles is speaking):

> "In Italy for 30 years under the Borgias, they had warfare, terror, murder, bloodshed—but they produced Michelangelo, Leonardo da Vinci and the Renaissance. In Switzerland, they have brotherly love, 500 hundred years of democracy and peace—and what did they produce? The cuckoo clock."

From Woody Allen (who works out of NYC): "The only contribution California has ever made to civilization is the right-hand turn on a red light." (Ed. note: C'mon Woody, we've done more than that! How about the goat cheese pizza?)

* *

Lee Iacocca's biography is still selling like hot cakes with the B.Dalton book chain having sold almost 300,000 hard covers alone. Iacocca's Japanese publisher tells him they have sold half a million copies. The Chrysler chairman receives 500 letters a day and 1,000 speaking offers per month. Why the amazing popularity of the book?Easy, it's the little guy (the Italian outcast) who rises to the top, tells off the blue blood (Henry Ford), storms off to a competitor and becomes a national hero. It's the financial version of Rocky. It's a repeat of the old American dream, "You too can become President." And, of course, Americans love a man who says what's on his mind, with no ifs, ands or buts.

* *

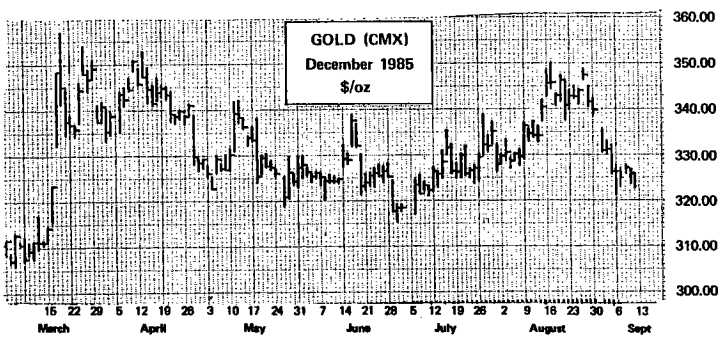
Growth: In 1960 with 13 teams the National Football League took in a gross of $13 million (20% of that came from TV). Last year the NFL with 28 teams took in $600 million (60% from TV). But whereas players used to do it for salaries of $5 to $10 thousand in 1960, the average NFL salary is now $190 thousand. ... More Growth: There were 13,000 restaurants in restaurant-mad Manhattan in 1984. This year the figure has climbed to 15,000. Because of sky-high rents, the trend for new restaurants is to out-of-the-way places and remote corners of Gotham. ... Still More Growth ... In 1946 the Wall Street Journal had 96,000 subscribers. Today the circulation

figures are 1.4 million -- largest of any daily in the nation.

* *

I was studying a breakdown of population growth by states in the US. Actual population losses (1980 to '85) occurred in Michigan, Ohio, Iowa and the District of Columbia. The biggest gains came in the following seven states: Alaska (gain of 28%), Nevada (16.6%), Texas (15.2%), Arizona (13.6%), Florida (13.6%), Oklahoma (13.3%), Colorado (12.6%). Most of these states (except Florida which has the weather) are in the West. Alaska is the last frontier and has low taxes. Texas, Nevada, Florida, have no state taxes. (I guess that tells us something.) In New England, the biggest growth was New Hampshire at 6.5%. NH also has no state taxes. New York and California (with state taxes at 10% or more) are super-expensive states. As I've often said about these two states, you really have to love 'em to stay there.

GOLD: I'm not going to say too much about gold in this Letter. On Sept. 9 the CRB Commodity Futures Index dropped to a new seven-year low of 217.2 -- hardly an indication of impending inflation. And as you can see on this Dunn & Hargitt chart of the December gold futures, gold is also acting as if there

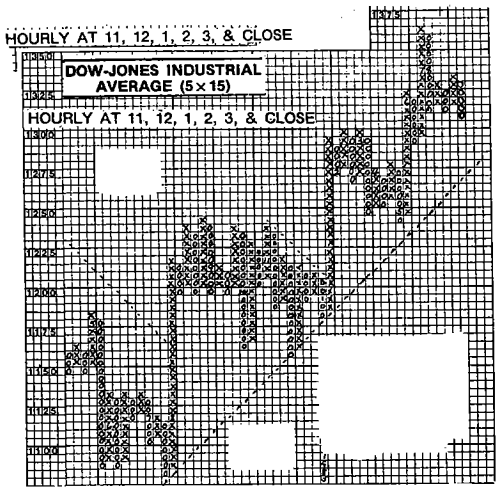


is no inflation. Following the June-August run-up, gold over the last few weeks has given back a major portion of its advance.

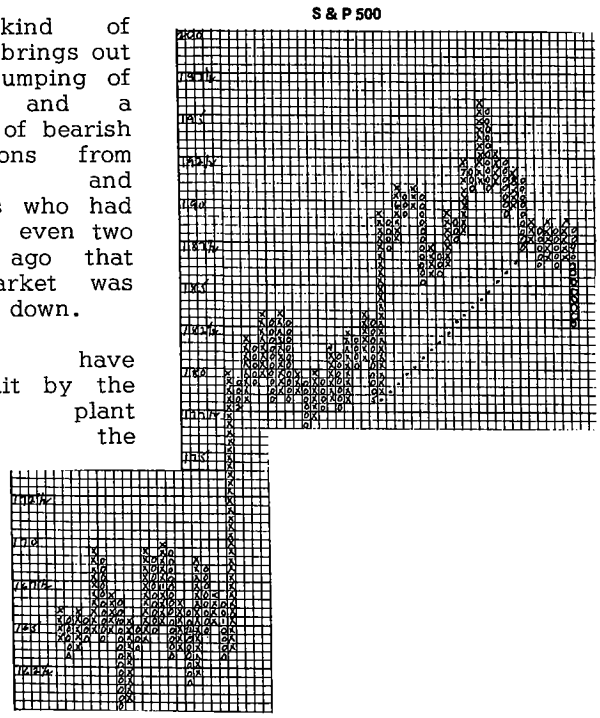
So what can we say of gold here? All I can say is that, technically, gold turned bullish in August and it's now backing off into a tedious trading range. I would say that 300 is an important level on the downside, and as long as spot gold holds above 300 there is hope for the gold-philes. My personal opinion -- gold and the precious metals are going to stay dormant for quite a while. The negative for gold is that there is no inflation. The positive for gold is that the US and world debt situation is shaky. The winner -- equilibrium. But I'm continuing to buy a few Canadian Maple Leafs each month. I'm very patient. You have to be in this business.

LATE NOTES: I am including two P&F charts (courtesy of Chartcraft, Larchmont, NY). Both charts show head-and-shoulders tops. But the Dow chart shows the Dow holding above its supporting (rising) trendline while the S&P chart shows that Average breaking below its rising (near-term supporting) trendline. Referring to the page 2 chart, my PTI has turned down (but grudgingly) while the A-D ratio has turned down decisively.

Lots of technical damage has been done to the market. But we knew that the market was overdue for a good reaction, and now we've got it. As a rule,



this kind of decline brings out fear, dumping of stocks and a variety of bearish predictions from writers and analysts who had no idea even two weeks ago that the market was heading down.



Utilities have been hit by the nuclear plant fears, the Transports have been hit by overvaluation (the D-J Transportation Average has been yielding a ridiculous 2.1%) and the Industrials have been hit by over-speculation, hysterical debt-creation and all sorts and varieties of takeovers and nonsensical financing. The purge should put the fear of God (or the desire for sanity) into Wall Street. I don't think the selling is over yet. Nobody's really frightened yet. They should be before it's over.

FINAL COMMENT: "Whom the gods would destroy, they first make mad." Is that a description of the Administration and Congress? I'm afraid so. Here's the government running deficits of $4 billion a WEEK, and what are they doing? They are hysterical about S. Africa while preparing to debate a muddled new tax bill. Does anyone see the idiocy in this? Has Reagan lost his mind? Has Don Regan ("Deficits don't count") captured Reagan's mind? Is the power-mad Regan an American Rasputin? Maybe it's the stock market alone that truly sees the picture. Maybe the sliding stock market is the only sane entity around.

NEXT MAILING: Oct. 2